MCTEAR WILLIAMS WOOD
business rescue & insolvency

briefing sheet

financing distressed companies

introduction

In the current climate it can be difficult to raise finance to fund the turnaround of a distressed business. Often directors find they have to put money in personally or look to family and friends for funding. This briefing sheet sets out our thoughts on how directors of family or SME companies can legitimately take steps to protect new funding in a company that either is, or is near insolvent, and is written from their eye view.

Before considering how to inject new funds or giving a new or additional guarantee you should first establish whether investment in the company is worthwhile. Is a better return achievable by closing the business and using the available funds for other investment opportunities? Alternatively is it appropriate to use an insolvency procedure to restructure the business first?

At all costs avoid putting good money after bad. At the risk of stating the obvious it is important to get the basics right.

- Make sure you understand what has gone wrong and that you know how to fix it.
- Prepare a business plan with fully integrated financial forecasts.
- Flex these forecasts to establish the company's tolerance to changes in key assumptions, like sales, gross margin, debtor and creditor days.
- Satisfy yourself that the risk is justified by the return. One way of sanity checking your plan is to discuss it with your fellow directors, your accountant or another trusted advisor.

If you decide to invest make sure that enough money is put in to fund trading until the company can be cash flow positive again and that you have a contingency plan if things go wrong. There is little point in getting halfway through your planned turnaround only to run out of money and have to put the company into liquidation.

the best ways to invest

Funding a turnaround by introducing share capital does have the advantage of improving the balance sheet but there may be a mountain of debt to climb before the company's finances are on a stable footing. An injection of funds by way of **new share capital**, which in a liquidation would only get repaid after all creditors have been paid in full, can require a huge leap of faith and unless there are special circumstances we wouldn’t normally recommend funding a turnaround in this way.

At this stage your focus should be on the return of capital rather than the return on capital. A potentially much lower risk way to finance a turnaround is to introduce funds by way of **a loan**, which should at least rank for repayment equally alongside other unsecured creditors.

However, you can do better still by **taking security** over the company's assets by the company granting you a legal charge, debenture or chattel mortgage. As long as the new security is properly in place, either prior to or at the same time as "new monies" are paid in, it is quite proper and should be readily enforceable. But be warned - there are many potential pitfalls and this should only be done through a specialist lawyer. There will be a host of considerations including:

continued overleaf

Call our business rescue and insolvency hotline on 0800 085 5070 or visit www.mw-w.com

financing distressed companies

continued

- Are the assets sufficient to cover the investment? An existing debenture may already be in place, perhaps to a bank, reducing the assets available to a subsequent charge holder. However, if they are repaid you should be ahead of the queue of ordinary unsecured creditors.
- If there is an existing debenture holder you should obtain their agreement to your subsequent debenture. This will usually be forthcoming if you enter into a priority agreement in their standard form although this process can take a while. Be prepared to show that your plan/proposals are comprehensive as this request might prompt a review of the company's existing facilities.
- If you don't have time to get the prior agreement of any pre-existing secured creditors you should be able to go ahead and create and register your new security at Companies House. As it is registered after any existing security it will usually rank behind it. Watch out for negative pledges in any existing security which aim to prevent the granting of other security - such a pledge is unlikely to invalidate the new security but could make it unenforceable against the prior charge holders. These are complicated areas and you should always seek professional advice first.
- If raising additional funds from a bank backed by a personal guarantee either make sure that the bank has taken security over the assets or do so yourself.

Dealing with prior secured creditors can get quite involved and substantial legal costs can be incurred in preparation of all the necessary documents. So instead you may wish to consider injecting funds by **purchasing specific assets**, for example unencumbered plant and machinery or vehicles. To avoid this being subsequently overturned by a liquidator this must be done at fair value, ideally in accordance with a professional valuation, and there must be a clear paper trail to record the payment and ownership. If there is an existing debenture any sale of company assets not in the ordinary course of business without the debenture holder’s consent may be void as against that debenture holder but not other creditors.

protecting existing loans

If a director has an existing loan and the company is, or is near insolvent great care should be taken when trying to repay that loan as it may give rise to a preference. It is possible at this stage to create a debenture to secure the existing loan without putting new money in but if the charge is to a connected party and the company does not survive for two years it will be void against a liquidator.

how can professional advisors help their clients?

If a director wants to invest in their company to fund a turnaround make sure that:

- Their business plan is realistic, the expected outcomes are worthwhile and they are not simply putting good money after bad.
- Consider if the investment should be in conjunction with an insolvency procedure. We are always happy to chat through whether this is appropriate.
- Consider your client buying specific assets at fair value.
- If the situation merits it, consider your client taking security preferably with the agreement of any prior secured creditors.
- If the company is, or is near insolvent and other creditors are not being paid avoid repayment of any existing or new loans.

The advice given here is generic and designed for guidance only. You should always contact a professional advisor for specific advice that is tailored to your own circumstances.

Call our business rescue and insolvency hotline on 0800 085 5070 or visit www.mw-w.com